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SPECIAL REPORT

ASEAN on the Rise

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INTRODUCTION

ASEAN on the Rise

With 610 million people, the 10-member Association of Southeast Asian Nations, or ASEAN, is less than half the size of China's market, but the region's quickly growing — and relatively big spending — middle class has become increasingly attractive to multinationals and foreign investors. The ASEAN bloc — which includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam — is nudging Chinese manufacturers aside as China's labor force begins to shrink and wages rise. Moreover, the planned launch of the ASEAN Economic Community (AEC) at the end of 2015 is likely to help sustain rapid economic growth in the medium term, analysts say.

This special report looks at the forces shaping the ASEAN region in 2015, most notably the effect of falling oil prices, along with in-depth views of two countries — Thailand and Indonesia — which are both facing unique challenges on the road to becoming economic powerhouses. Also included is an interview with Kan Trakulhoon, president and CEO of SCG, one of Thailand's largest conglomerates, on managing a workforce in a volatile economic environment.

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ASEAN in 2015: Will Lower Oil Prices Interfere with Rapid Growth?

THE 620 MILLION PEOPLE LIVING IN THE ASSOCIATION OF SOUTHEAST ASIAN NATIONS, or ASEAN, are facing some potentially big changes in coming months, given lower oil prices and the formation of a regional economic community. The net impact is far from certain, however, and forming an economic community is no panacea, as anyone familiar with the tribulations of the European Union knows. Still, the planned launch of the ASEAN Economic Community (AEC) at the end of 2015 is likely to help sustain rapid economic growth in the medium term, analysts say. And the recent decline in crude oil prices to their lowest level in more than five years also will boost most ASEAN countries that are net importers of oil.

Various research institutes estimate that ASEAN could double its combined GDP by 2025 thanks to the AEC. But there are obstacles to liberalizing ASEAN's financial service industries and capital markets, and to the movement of skilled labor, among other issues. Some of the less developed ASEAN countries, such as Cambodia, Laos, Myanmar and Vietnam (CLMV), will be slower to achieve their targets for trade liberalization, and the economic development gap between the CLMV and the other six, more affluent ASEAN countries (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand) remains wide. Moreover, the risk of political instability looms, especially in Thailand and Myanmar.

The Asian Development Bank (ABD) in December estimated GDP growth in developing Asia at 6.1% in 2014, down from its 6.2% forecast in September, and for 2015 it lowered its forecast to 6.2% from the previous 6.4%. The ADB also cut its GDP forecast for the 10 Southeast Asian countries to 4.4% in 2014 from its earlier forecast of 4.6%, and to 5.1% for 2015 from the earlier 5.3%. "While growth in the first three quarters of [2014] was somewhat softer than we had expected, declining oil prices may mean an upside surprise in 2015 as most economies are oil importers," said ADB chief economist Shang-Jin Wei.

Oil remains one of the wild cards for the region, as well as for the global economy. Saudi Arabia said in December that it would not cut output to prop up oil markets even if non-OPEC nations do so, signaling that the world's top petroleum exporter plans to ride out the market's biggest slump in years. "There will be some losers and some winners in ASEAN, depending on whether they are net exporters or net importers, because of lower oil prices," says Wharton finance professor Franklin Allen. "It seems that the price fall is here to stay since the Saudis decided that they want low oil prices so they do not get gradually squeezed out."

> **ASEAN has "liberalized trade in goods, but they still have big differences over liberalizing trade in services and liberalizing investments in the service sector, and allowing greater labor mobility."**
>
> — Ryo Ikebe

Lower oil prices will help some ASEAN oil and gas importers like Thailand, which is the biggest beneficiary in Asia because it is the most dependent on road transport. Lower oil prices hurt Malaysia, a net oil exporter, and Myanmar, which is a net gas exporter. But IHS Economics Asia Pacific economist Rajiv Biswas nevertheless expects Myanmar's growth to moderate only slightly to 7.6% in 2015 from 7.8% in 2014.

REGIONAL UPSWING OVERALL

London-based Capital Economics is forecasting emerging Asia's regional GDP growth will rebound to 4.7% in 2015 from an estimated 4.3% in 2014 since most countries will benefit from lower oil prices and loose monetary policies, along with a gradual recovery in global demand. "We expect Thailand's growth to pick up from 1% in 2014 to 3.5% in 2015," says Daniel Martin, a senior economist at Capital's Singapore office. "A lot of that is rebound from the political crisis. We are still slightly below the consensus this year because we think Thailand has some debt issues. It ran up a lot of credit growth rapidly over the last five years. We think that is going to be a drag this year and for a couple years after that."

"[ASEAN] is a tremendously diverse group, from very poor to quite rich countries, so it will be tricky for them to make [the financial portion of the regional economic pact] work."

— Franklin Allen

In Indonesia, the region's biggest economy with 40% of its total GDP, the situation is even more complicated. Although it is a resource-rich country that used to export large quantities of oil, Indonesia is now a net oil importer and the slump in natural gas prices and commodity prices is hurting. "The changes in global commodity prices will be a net drag for Indonesia. We expect its growth to be stuck at about 5% this year, unchanged from 5% in 2014, as the country [implemented] a quite tight monetary policy," Martin says.

Biswas expects Indonesia's growth to remain stable at 5.1% in 2015, unchanged from 2014. "There is some better news in some other countries like Thailand," he adds, although he is not as bullish as Martin. "Thailand was weak in 2014 because of all of the political problems in the first half of the year and the economy was almost in recession. Our estimate of growth in Thailand last year was 0.5% and very weak. We expect some improvement in 2015 because the military government announced a big stimulus package in October." Biswas expects GDP growth of 2.9% in 2015. "[The better economic growth in Thailand] is important because from 0.5% to 2.9% growth for the second-biggest economy will have quite a significant effect on overall ASEAN growth."

Malaysia, ASEAN's fourth-biggest biggest economy, has been performing well — up 5.9% last year. But lower oil prices will take a bite this year since the country is an exporter of both oil and gas.

"What we are going to see this year is that government revenues will be affected because they are quite dependent on oil and gas revenues," Biswas says. However, the impact will not be huge because Malaysia's economy is more diversified, with strong tourism, and also manufacturing and exports of electronics. "We think the growth will be 4.8% [this year], a bit softer."

Martin is optimistic about prospects for the Philippines. "We expect 6.5% growth this year and 6% in 2014 because their manufacturing sector is doing well and it is attracting foreign manufacturers from China." The ADB downgraded its forecast for the Philippines slightly for 2014 to 6% from 6.2% after growth in the first nine months of the year reached only 5.8%. "Continued strong household consumption bolstered by steady growth in remittances and increases in domestic employment will, along with improved government spending, support the pickup in growth next year, the ADB said in a December report.

Vietnam likewise is doing fairly well, having increased its electronics exports to help balance out any impact from lower oil export revenues. Martin puts growth at 6% this year from 5.8% in 2014. "So much depends on what would happen to the banking sector, which has been a real drag," Martin notes. "Credit growth has been much slower. I think there are quite a lot of issues behind that recapitalization of the banks, some bank mergers and consolidation factors."

'FRONTIER' ECONOMIES

As for the other ASEAN "frontier economies," the outlook is for continuing strong growth. Biswas expects 7.4% GDP growth in 2015 for Laos and 7.7% in 2016, compared with an estimated growth of 7.3% in 2014. Myanmar, which is starting from a much lower base than its neighbors, will see growth at 7.6% in 2015 and 7.3% in 2016, compared with 7.8% estimated growth in 2014, Biswas says. He predicts Cambodia to have 8.2% growth in 2015 and 8.1% in 2016, up from 7.8% in 2014.

Despite the various uncertainties, growth is expected to remain strong. In its "ASEAN 2025 Survey Report," the Japan International Cooperation Agency (JICA) forecast that the region's GDP will grow by 5% a year, doubling to $4,628 billion in 2025, with Indonesia, Thailand, the Philippines and Malaysia accounting for more than 70% of total GDP. "Other international organizations like the ADB have similar forecasts for ASEAN by 2025," says Koichi Ishikawa, a professor at Asia University and an ASEAN expert. “Unless something unexpected happens, they will be able to double their GDP by 2025.”

As population growth slows, GDP per capita will also rise, growing between 8% to 9% for the developing countries and 3.5% to 6.5% for the ASEAN 6. JICA expects ASEAN's population to increase 1% annually from 2015 to 2025 to reach 695 million by the end of 2025. Meanwhile, the size of the middle- and higher-income classes will increase to 76.5% by 2025 from 56.4% in 2010.

Experts are divided over the impact of the AEC for mid-term ASEAN economy. Ryo Ikebe, director of Asia and Oceania division at the Japan External Trade Organization and an ASEAN expert, says the launch of the AEC later this year is only the beginning of a long process of market opening. “They have liberalized trade in goods, but they still have big differences over liberalizing trade in services and liberalizing investments in the service sector, and allowing greater labor mobility,” Ikebe notes. “The main six ASEAN countries have abolished tariffs on 99% of items of goods trade, so that is almost completed. But we have to see how far Cambodia, Laos, Malaysia and Vietnam will go in following the ASEAN 6 by 2018.”

For countries that are just beginning to build capital markets and modern financial systems, the process will be more complicated. “It is a tremendously diverse group, from very poor to quite rich countries, so it will be tricky for them to make this work,” says Allen, who also is a professor at Imperial College in London and head of its Brevan Howard Centre for Financial Analysis.

ASEAN will make significant progress and that will accelerate growth, but full market opening is unlikely to occur by the December 31, 2015, deadline, says Murray Hiebert, a senior fellow and deputy director of the Sumitro Chair for Southeast Asia Studies at the Center for Strategic and International Studies (CSIS) in Washington, D.C. “Liberalization in financial and other services, freer capital flows and labor mobility are expected to lag behind. In many ways, the deadline is more aspirational than binding; the grouping's leaders never thought that less-developed economies like Laos and Myanmar would achieve all the integration goals by the end of 2015,” Hiebert notes. “Even some of the more developed economies like Indonesia will struggle to meet all of their targets.”

Liberalizing financial services would foster more resilient economic growth, Hiebert adds. “But some ASEAN countries are anxious about opening up financial services and capital markets out of fear of financial contagion and exchange rate volatility, even though integration would provide opportunities for risk sharing.”

Market opening implies an acceptance, to a certain extent, of a division of labor, and there will be losers and winners in various industries, says Ikebe. “For example, you will not be able to have a car industry in [all] 10 countries. One or two countries will have an auto industry or electronics industry. There will be a clear ranking in terms of manufacturing industries among the AEC countries and there will no longer be tariff protection after the launch of AEC.”

“Some ASEAN countries are anxious about opening up financial services and capital markets out of fear of financial contagion and exchange rate volatility, even though integration would provide opportunities for risk sharing.”

— Murray Hiebert

While the plans for AEC are transparent, trade arrangements with other ASEAN partners are more complicated and obscure. The RCEP, or Regional Comprehensive Economic Partnership, joins the ASEAN countries and six other major regional economies, which have free trade arrangements. RCEP is intended mainly to harmonize differences between those various trade agreements. “It is hard to calculate the impact of the RCEP on economic growth because the negotiation partners have not been transparent in spelling out exactly what issues they plan to tackle in the agreements. That said, harmonizing differences between the different agreements with ASEAN will still benefit the regions,” Hiebert says.

The potential impact from trade talks among the dozen Pacific Rim countries in the Trans-Pacific Partnership is even less clear. Vietnam, Brunei, Malaysia and Singapore are members of the U.S.-led effort, which also includes Japan, Chile, Peru, Mexico, Canada, New Zealand and Australia. Extending the free trade arrangements of RCEP would be a natural progression, says Biswas. “TPP is more complicated because of other major partners like the U.S., which is not in RCEP. So implementing the building blocks for RCEP can be done soon, though there are still doubts over when TPP will be implemented.”

In Myanmar, apart from trade dealings, ASEAN faces two major political sources of uncertainty. Parliamentary elections are due late in the year, and the country is struggling with violence between majority Buddhists and the minority Muslim Rohingyas, as well as significant economic challenges. "Myanmar is still only a minor player in ASEAN's economy so it is not likely that the election in 2015 will have a major impact on ASEAN," Hiebert says. "But Thailand's political instability could have a bigger impact, particularly if it delays Thailand's ability to meet AEC goals. More political instability is also possible in Thailand if the military, which has already said it will delay elections from late 2015 to 2016, postpones the elections indefinitely. This could prompt protests and result in more instability and economic turmoil."

NO CURRENCY UNIFICATION

Even if the AEC launch goes smoothly, the result will not be a unified market along the lines of the European Union (EU), experts say. "EU members give up their national sovereignty in terms of issuing their own currencies and trade, and hand it over to EU," says Ishikawa of Asia University. "ASEAN is different and the different sovereign nations are cooperating to liberalize their markets. They do not plan to unify their currencies."

In many respects, a unified economic community remains a distant prospect for the collection of developing nations within ASEAN markets scattered among the archipelagos and mountainous peninsulas of Southeast Asia. The economic and demographic gaps in the region are vast. "For example, Indonesia's population is 600 times bigger than Brunei's. In terms of GDP per capita, Singapore's is the highest and is 63 times bigger than Myanmar's," Ikebe notes.

Perhaps the biggest challenge will be in integrating policies of countries with vastly differing political systems. "For example, democratic Indonesia has to be more responsive to the demand of domestic business, NGOs and labor unions than does more authoritarian Singapore," says Hiebert. "This is one reason why ASEAN has no interest in forming a single market with a united currency like that in the EU." ❋

Thailand: Can the Whimpering Tiger Spring Ahead?

GENERALLY SPEAKING, A COUP D'ÉTAT IS NOT GOOD FOR BUSINESS. Political upheaval usually scares away investors who become unsure of their footing under a new regime that has muscled its way into power.

Thailand's coups have been an exception. In 18 other such takeovers since absolute monarchy ended in 1932, none have led to a financial crisis. Investors are betting that it will be the case again this time around, even if they cannot count on 87-year-old King Bhumibol Adulyadej, who is ailing, to intervene once again as a stabilizing force.

Since General Prayuth Chan-ocha and his troops took control of the Thai government in May 2014, ending civil strife over the populist policies of ousted former Prime Minister Yingluck Shinawatra, the benchmark stock market index Thai SET has been among the best performers in the region. It is up 7.15% year-to-date as of February 18 and gained 25.27% in one year. Compare that to Indonesia's Jakarta Stock Exchange Composite Index, up 3.13% thus far in 2015 and 19.79% in one year; and Malaysia's Kuala Lumpur Composite Index, up 2.93% year-to-date and 2.04% in a year.

The Thai baht has stayed resilient as well since the coup, hovering between 32 to 33 baht to the U.S. dollar in the past 52 weeks. In fact, the currency is a bit too strong for the country's main business group, the Thailand Chamber of Commerce, because it hurts exports at a time when overseas shipments have been falling, according to a February 11 story in *The Wall Street Journal*. The group has called on the central bank to clamp down on the baht. Meanwhile, private equity firms continue to invest in Thailand despite the political uncertainty, according to the December 2014 issue of *Private Equity Analyst*, a Dow Jones publication.

"Thailand has a relatively robust investment environment," says Philip Nichols, Wharton professor of legal studies and business ethics, whose research interests include international trade and emerging economies. "Thailand is regarded pretty well among business people for its low regulatory burden, and with a low regulatory burden usually comes less corruption."

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Indeed, it is Thailand's weakening economic outlook that has so far overshadowed its political problems and risks. Like other markets, the country is being hurt by a slowing economy worldwide, especially in China, its largest export market. On January 13, the World Bank cut its global GDP outlook for 2015 to 3% from 3.4%, and to 3.3% from 3.5% for 2016, according to its semiannual Global Economic Prospects report. The International Monetary Fund has followed suit.

Thailand's National Economic and Social Development Board said the economy, the second largest in the region after Indonesia, grew by 0.7% in 2014. It slashed its growth outlook several times last year down to 1%, according to a November 2014 story in *Reuters*. Weaker exports, a drop in tourism and lower private consumption were the main culprits. Exports make up around 70% of the economy. While the country's central bank, Bank of Thailand, kept interest rates steady when its Monetary Policy Committee met on January 28, it nevertheless said that going forward "monetary policy should stay accommodative to provide continued support for the economy." Indonesia has already lowered rates, while Singapore eased its monetary policy by taking measures to tamp down even more on the appreciation of its currency.

Geopolitics is also playing a role in political uncertainty. China has been cozying up to Thailand, supporting the new military government, while the U.S. has wagged its finger and called for elections to return the country to democracy soon. While it is unclear when, or even if, Prayuth will end martial law, hold snap elections and step down as prime minister, the bigger question confronting Thailand is less the political drama unfolding and more its longer-term economic position.

> **"When Thailand was already manufacturing electronics and textiles for the global market, China was still a closed country."**
>
> – Mauro Guillen

Wharton management professor Mauro Guillen says that Thailand, along with its smaller Southeast Asian neighbors, has mainly stayed put economically as China, India and even Vietnam are charging by. "They have stayed more or less where they were in the last 10 years or so," he notes. "The problem they are facing is they haven't made much progress. At the same time, there are other countries coming up from below that are catching up. That can be highly problematic."

ONCE A 'TIGER'

According to Guillen, the Southeast Asian nations of Thailand, Indonesia and Malaysia have more mature economies than China or India, even though they are not making as many headlines. In the 1970s and 1980s, Thailand and Malaysia became important producers of textiles, electronics parts and components. Thailand was also the largest rice exporter in the world until recently, and a major producer of hard drives. "These countries set up manufacturing operations earlier than China," he says. "When Thailand was already manufacturing electronics and textiles for the global market, China was still a closed country.... It didn't open up until the 1980s." Back then, Thailand, Malaysia and South Korea were among the "tiger" economies, Guillen notes.

But China and India are the heavyweights today because of the sheer size of their population. In 10 to 15 years, the Chinese and Indian consumer markets will be bigger than the U.S. and the European Union, Guillen predicts. Then there are the economies of Thailand, Malaysia, Indonesia and others in the region. "It's very clear these are going to be the largest markets in the world, and that has important consequences for companies like Coca-Cola," Guillen notes. "Right now, they make most of their money in the U.S. and Europe. That's no longer going to be the case."

This year, the 10 countries making up the Association of Southeast Asian Nations (ASEAN) are banding together to create what would become the world's largest emerging market with a $2.4 trillion economy. The region is home to 620 million people, or nearly a tenth of the world's population. The participating nations are planning to lower tariffs, increase investments across borders and ease trade flows. The ASEAN countries include Burma, Brunei, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

Stephen Kobrin, Wharton emeritus management professor, says that there are hurdles to overcome before the ASEAN countries can become an effective single market. "Lack of infrastructure is a major issue," he points out. "If you want to be a single market, you have to be able to move goods around and you have to be able to communicate." That means adequate ports and roads must be built, which can be a challenge for some countries that comprise thousands of islands. They also must get around the problem of massive traffic jams tying up transport of goods within their cities, he notes.

Wharton management professor Peter Cappelli adds that the region's economies can be quite volatile. "Although the region is huge in its economic activity, the individual countries are reasonably small, and typically their economies are not so diverse," he notes. "That increases the volatility: When a sector like tourism is down, the entire economy is down." As such, businesses in the region have to learn to deal with that volatility. Hiring and laying off people as business changes might be too slow to be effective. Therefore, companies have to think through other arrangements, including joint ventures, leased employees and contract work, Cappelli says. However, "all these practices come with risk."

Kobrin notes that ASEAN nations do offer several benefits: low cost manufacturing; a young, trainable labor force; abundant resources and technological innovation. Moreover, Singapore is a well-developed financial center, he says. Vietnam is an up and coming market where wages are even lower than China's, Guillen adds. "If you want to bet on a growing economy that's going to be very attractive for a long time, go to Vietnam," he says. "Vietnam is a truly emerging economy."

Therein lies Thailand's dilemma. It is more expensive than Vietnam, lacks the scale of China and is not as developed as Japan and South Korea. "Thailand, Malaysia, Indonesia — these countries are somewhere in between," Guillen says. "They cannot compete with the low wages in Vietnam and Bangladesh, but they are not as sophisticated as South Korea. So they are somewhere in the middle. It's OK to be somewhere in the middle for a while, but it cannot be forever."

Guillen notes that South Korea started out in the same state as Thailand. It was a low-wage country that produced products of inferior quality. "Today, [Korean] cars are really good, and Samsung is the largest electronics company in the world." Singapore has made the same transition, and its citizens are among the wealthiest in the world. For Thailand, Indonesia and Malaysia to make the same jump, they must invest in education and infrastructure to boost productivity, and continue to develop their local markets instead of being overly reliant on exports, he says.

Moreover, they have to provide other advantages besides being cheaper. "You cannot be a rich country if you always compete on the basis of low wages and low costs," Guillen points out. "It's hard enough to compete on low wages — there's a lot of competition. Many countries have low wages. But it's even harder to make the transition from being a low-cost producer to being a producer of higher value" products and services.

At least Southeast Asian countries are learning from previous crises. For example, the 1997 Asian financial crisis that started in Thailand and then swept up Malaysia, South Korea, Indonesia and others in the region led to the development of stronger financial systems. "That is something that they learned in the last 15 years," Guillen notes. "They accumulated currency reserves to avoid being in the situation where they could be at the mercy of the markets…. Their central banks have gotten better. This is really important."

Finally, these countries have been rebalancing their economies. They used to overinvest in manufacturing and remain heavily dependent on exports, but the domestic market is rising in importance. "You start creating a middle class, people with higher wages, so they will consume more," Guillen says. "That is very healthy." But Thailand has a long way to go before it can become another South Korea. "This is not an easy transition to make," he adds, noting that it is particularly tough for the country now because of the political sideshow.

RED SHIRTS VS. YELLOW SHIRTS

Thailand is an anomaly compared to its neighbors. "Thailand is the only place in the whole region that was never occupied," Nichols says. "It's got a really strong sense of national identity, cultural identity and of course they revere the monarchy. But at the same time, the people are exuberant in their voting and politicking, and then you've got a very interesting intervention by the military over and over and over again." The country also enjoys a free press, he adds.

> **"When a sector like tourism is down, the entire economy is down."**
>
> – Peter Cappelli

There are two main political parties in Thailand's parliamentary-style government: The populist Pheu Thai party supported by urban poor and rural citizens, and the Democrats, which is backed by the Bangkok elite and royalists. The populists wear red shirts to show their support of the party; the elites wear yellow, which is the color of the monarchy. Ousted Prime Minister Yingluck led the Pheu Thai party; her brother Thaksin Shinawatra, a former prime minister and telecommunications tycoon, is in self-imposed exile in Dubai after facing corruption charges.

Nichols said Yingluck was swept out of power due to the confluence of several factors. Massive flooding hit the country right after she was elected, coming during a time of recession. She proposed legislation that would extend amnesty to anyone who was arrested for politicking in the aftermath of the 2006 coup, which included protesters occupying a Bangkok airport, but it was taken the wrong way. Her supporters felt betrayed because they thought police officers who mistreated them would get a pass. Meanwhile, the opposition assumed that Yingluck was clearing a way for her brother to return to Thailand without jail time. Thaksin was ousted in the 2006 coup.

"The legislation never said that but it kind of morphed into that in the popular mind," Nichols notes. "The streets erupted. This time, there was no support from the poor and rural folks. They also didn't like the legislation, and that's what sent everything into a spiral." That was when Thailand's Constitutional Court stepped in and removed Yingluck, not for the proposed legislation, but for abuse of power after unlawfully transferring a senior security official. The court said the removal paved the way for the appointment of her relative to the job. In the power vacuum that followed, the military stepped in.

Yingluck would later be impeached for her administration's handling of a rice subsidy program that backfired. To fulfill a campaign pledge to help rural farmers, her party had a plan to buy rice at above-market rates, stockpile the inventory to drive up global rice prices and then sell. The plan failed after India, Vietnam and other countries stepped up their exports to take up the slack, leaving Thailand with billions of dollars in losses. She faces up to 10 years in prison if corruption and negligence charges stick, according to a January 23 story published in *The New York Times*.

Yingluck has refuted the charges. "Democracy is dead, along with the rule of law," she wrote on her Facebook page. "I will fight to the end to prove my innocence." ❋

Indonesia's New Path Offers Reasons for Confidence

BEYOND JAVANESE FOLKTALES AND BALINESE BATIK TEXTILES, Indonesia is a potential economic powerhouse with a captivating story. With a new popular president, Joko Widodo, who took office in October, all eyes are on the largest economy in Southeast Asia and how Widodo will lead the nation into the future.

"It's the million-dollar question," says Philip Nichols, Wharton professor of legal studies and business ethics, referring to how the new government's plans will work out. "There are few places that have sustained growth through the entirety of the recession [like Indonesia], but it's still a fragile place."

While the economic spirit of Indonesia proved resilient during the global financial crisis, the country is now experiencing its slowest GDP growth in five years. And while recent governments have generally steered Indonesia in the right economic direction, the nascent administration must overcome big challenges to elevate the country to its full potential.

More generally, Indonesia has a rich, diverse culture that adds to its vibrancy at the same time it poses additional challenges. The archipelago nation is a mosaic, with more than 700 languages spoken by 254 million people spread out over 17,000 islands, and with more than 87% of residents practicing Islam, making it the world's largest predominantly Muslim nation.

One of Indonesia's biggest strengths is its demographic profile. It's the fourth-most populous country in the world with an average age of just 29, which translates into a robust labor force. "Right now, they have a demographic advantage. It's the youngest population in the region, but that won't last forever," notes Petar Vujanovic, head economist of the Indonesia desk at the Organisaton for Economic Co-Operation and Development (OECD). "By 2030, they'll deal with an aging population."

Another asset is the government's commitment to democracy, with a focus on economic growth and development. The first direct presidential election came less than 20 years ago. Prior to that, Indonesians had been under authoritarian rule ranging from Indonesian dictators to Dutch imperialists.

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>
> – Philip Nichols

In the most recent election, Widodo gained widespread popularity, pledging to fight corruption and reduce poverty. A former furniture maker, he got his political start when he became mayor of Solo, a city of 500,000 people in the middle of Java. As the son of a woodmonger, he interacts with local crowds and encourages his staff to cut down on excess, like holding meetings at luxury hotels. He flew economy class on Indonesia's Garuda Airlines to his son's university graduation in Singapore instead of jetting off on the presidential plane.

But as a political outsider, Widodo still needs to rely on political cronies of the old regime because his power base remains precarious. Though the cabinet he appointed was vetted by an anti-corruption commission — the first time the Indonesian cabinet has undergone any screening — members are "dominated by leaders of state and domestic enterprises. It's a CEO cabinet," says Budy Resosudarmo, economics professor, head of the Indonesia Project at Australian National University and currently a fellow at Harvard University.

WILL THE ECONOMY HAVE VIGOR?

As the largest economy in ASEAN (Association of Southeast Asian Nations), a member of the G20 and one of the few economies experiencing a growth rate greater than 5%, Indonesia has the potential to play a pivotal role in the regional and global recovery. Yet, the pace of Indonesia's growth has reached the slowest rate since 2009. In 2014, Indonesia's GDP growth rate was 5.1%. This year, the World Bank expects flat growth at 5.2%, while Widodo is targeting 5.7%. "We don't think that's achievable with recent figures. The trend is declining," says Vujanovic. Given the slowdown in China, that might not be surprising. Still, growth may pick up before long, according to the World Bank, which forecasts that Indonesia's GDP will rise to 5.5% in 2016 and 2017.

> **"We see good efforts to combat corruption and poverty. Indonesian economics are not that bad but not as good as they could be."**
>
> – Budy Resosudarmo

Beyond that, experts are cautious. "My feelings are a bit mixed," says Resosudarmo. "Widodo seems to be taking the country in the right direction, but there may not be enough reformers in the cabinet. We see good efforts to combat corruption and poverty. Indonesian economics are not that bad but not as good as they could be."

Some are more optimistic that growth will rise as investors will feel more confident. Reny Eka Putri, an analyst at Bank Mandiri in Indonesia, forecasts stronger economic growth with "structural reforms as keys to improving the performance of national exports and fostering confidence in investment opportunities in Indonesia." To become a high-income country by 2030, the World Bank says Indonesia needs a 9% growth rate to escape the middle-income trap, an economic plateau where some economists believe developing countries often find themselves unable to move to the next level of development, which would mean being able to compete toe-to-toe with more economically advanced nations.

Recently, in a surprise move, Bank Indonesia cut its benchmark interest rate to 7.5% in response to global deflation pressures. With China's slowing growth, euro zone deflation and falling commodity prices, the country is being cautious given that it depends heavily on commodity exports. "Global demand is not yet recovered, and uncertainty remains," notes Arianto Patunru, an economics professor at Australian National University. "Domestically, the era of the commodity boom has ended, while the economy still relies heavily on non-tradables [service sector]." The move is also aimed at keeping Indonesia's current account deficit in check. Currently, it's about 3% of GDP.

Moreover, in addition to the slowdown in China, Japan's outlook is also uncertain following an increase in the national sales tax that appeared to undermine a fledgling recovery. These countries are among Indonesia's biggest trading partners, and any hiccups there could deeply affect Indonesia's growth, says Patunru. Adds Vujanovic: "The weakening in trade partners in the region can hold the country back for the next year or two."

At the same time, the value of Indonesia's rupiah has dropped to its weakest level against the U.S. dollar since November 2008, sliding some 6.5% since November 2014 alone. Bank Indonesia's Governor Agus Martowardojo told Bloomberg that the currency movement was "beneficial" in making Indonesia's exports more competitive. "I'm not sure whether this is a subtle signal that Indonesia is joining the currency wars," said Khoon Goh, a Singapore-based strategist at Australia and New Zealand Banking Group Ltd.

Even if true, however, the World Bank estimates Indonesia's rupiah has been overvalued for some time anyway. Vujanovic explains, "It's been depreciating on its own for a while now for a number of reasons. Trade has been underperforming, and it's been relying on foreign sources of funding, which leads to fiscal imbalances."

FALLING OIL PRICES' SURPRISING EFFECTS

While some countries are reeling from declining oil prices, it's been fortuitous timing for Indonesia. On January 1, Widodo eliminated fuel subsidies, which had kept pump prices to $0.66 per liter and had largely benefited the rich, who could afford cars. But gas prices at the pump went on to fall lower than the earlier subsidized fuel price as oil prices dipped even further. At least so far, the trend has "muted any political reaction for the reduction in fuel subsidies," notes Nichols. In the past, there have been violent riots over fuel costs.

"Indonesia is a net importer of [light] oil used for transportation. It was a member of OPEC, but it exited when supply did not kept up with domestic demand" in 2008, says Vujanovic. Patunru notes that creates an obvious downside effect, too: "That means there is a repercussion effect of the falling oil prices on the revenue side."

Eliminating fuel subsidies, however, could also open up the market for foreign investment in the energy sector. Because of the government's past price fixing, foreign companies couldn't compete with the low gasoline prices at the filling stations of state-owned Pertamina. While the lifting of price controls might lead to an increase domestic production, don't expect energy imports to fall anytime soon. In fact, by 2018, Indonesia may be the world's largest importer of gasoline. Already, it's the world's eighth-largest consumer of gasoline. That's not surprising, given that more than 1 million new cars and almost 8 million motorcycles are sold in Indonesia annually.

Dropping the fuel subsidies will have a major effect on the nation's budget. Fuel and electrical subsidies have accounted for 20% of government spending, notes Vujanovic — the 2015 allocation was $18 billion. Some of the funds now are being shifted to anti-poverty programs, an area in which increased spending had been a major campaign pledge for Widodo. Indonesia now has the "fiscal space to do this with the elimination of fuel subsidies, and the new government is falling along those lines," says Vujanovic.

Lifting more people out of destitution is a major goal for Indonesia. "The Indonesian government is committed to a social security system that protects the neediest members of society," says Jeffrey A. Sheehan, former associate dean of international relations at Wharton. "Their means are measured, and if they need support, they get it. They don't just get [the money] because their uncle is governor of some province. One of the key things for economic development is for people to trust the government."

Recently, Widodo's government began issuing national cards to give cash transfers of $15.56 a month to poor people. Half of all households survive on an income clustered around the national poverty line of $15.44 per month, according to the World Bank, although officially about 11.7% of Indonesians actually live in poverty. The income top-up program, the largest in the world, will benefit one-third of Indonesia's population. Resosudarmo estimates "poverty will be reduced by 15%" over the next few years.

What's more, Widodo is using mobile-phone SIM cards to be topped up at banks and post offices to eliminate the movement of hard cash, which can easily get diverted through theft and corruption. "Every time you're moving cash around in a disparate country, you have to worry about a lot of it getting swayed," explains Nichols. "There's corruption even at the lowest level." Moreover, the cards also provide expanded access to health care services and educational programs.

Widodo's focus on these social programs will help raise Indonesia's rank in the United Nations Human Development Index (HDI), a single number quantifying a country's quality of life in terms of health, education and income. In 2013, Indonesia was ranked 108 out of 187. The country attained a HDI score of 0.684, a 45.3% increase from its score of 0.471 in 1980. There have been major strides but Indonesia still has a long way to go. Vujanovic notes, "Indonesia has been doing a good job over the last 20 to 30 years of reducing poverty. The benefits of growth have been shared equally among all segments of society. The strong and sustained growth has lifted all boats."

"The Indonesian government is committed to a social security system that protects the neediest members of society."

– Jeffrey A. Sheehan

An additional benefit of the fuel subsidy cuts: About 60% of the money saved can be used for infrastructure investment. "Infrastructure presents extraordinary challenges for a nation with thousands of islands which can be accessed with ferries and airplanes," says Nichols. "There's only one big port in Jakarta and it's lacking in efficiency, thereby inhibiting interregional and export markets," adds Vujanovic.

The good news is "the government has a strong focus on domestic and international maritime issues. It's one way of involving businesses, and people in remote regions don't miss out on opportunities," explains Vujanovic.

THE FOREFRONT OF ASEAN TRADE

If Indonesia can greatly improve its infrastructure, an increase in trade will follow. The country is a major player in ASEAN, accounting for 40% of the region's population. And the ASEAN trade bloc, with a combined GDP of $2.31 trillion, is the third-largest after the North American Free

Trade Agreement and the European Economic Area. In addition, Indonesia's geopolitical position can give them leverage. Resosudarmo notes, "ASEAN is equal in land mass to the whole of Latin America and its size is one of the things that can balance power in Asia against China."

This year, the ASEAN Free Trade Agreement will come into full effect. "A big chunk of existing trade barriers will be removed," notes Vujanovic. Essentially, most of the import and export duties on items traded between ASEAN countries will be eliminated.

Already, six ASEAN countries, including Indonesia, have a free trade agreement with China that has eliminated tariffs on most goods. This year, the remaining four will join the ASEAN-China Free Trade Area, opening up the ASEAN region even wider for investments. Watch for manufacturing to be affected significantly as foreign companies take a keener look at the robust labor force as a way to tap into the lucrative Chinese consumer market, as well as providing for the U.S. and Europe.

Opening up the country to foreign investment in areas like infrastructure, manufacturing and banking, along with eliminating protectionist policies, will further boost growth if the past is prologue. Foreign direct investment flows into Indonesia have climbed sharply since Indonesia has been politically stable, according to the World Bank.

However, despite all of the advances, Resosudarmo worries Indonesia may not foster enough foreign trade, with cabinet members possibly holding onto an "inward-looking strategy dominated by protectionist interests." In the past, Indonesia has had a rough history with outside firms. "There's an extraordinary distrust of foreign investors. They've been bitten before and they've been bitten hard," says Nichols.

Still, with the new leadership, foreign investors are starting to feel optimistic. For one thing, Widodo's government is focused on making the country more conducive to starting businesses. "He knows Indonesia needs a supportive business climate in order for the country to grow," notes Nichols. In the World Bank's Ease of Doing Business Index, Indonesia is ranked 114th right now and the government would like to be in the 70s, adds Vujanovic.

One straw in the wind: Recently, China's Foxconn, the world's largest contract electronics manufacturer and maker of Apple components, signed a $1 billion deal to relocate production from Shenzhen to Jakarta to take advantage of lower wages and a younger workforce. Vujanovic notes that shifting Indonesia's economy from agricultural and mining-based to a services and manufacturing economy is important for sparking GDP growth, and the government understands that.

Elsewhere, the World Bank has developed a strategy with Indonesia to accelerate economic development through 2025 by focusing on connectivity and logistics, access to finance for small and medium enterprises, and infrastructure and energy investment. For instance, Indonesia has the largest geothermal resource in the world, and the Geothermal Clean Energy Investment Project is aimed at scaling up its capacity by 40%. The World Bank is helping with financing but the technology transfer from foreign firms will be essential to tapping Indonesia's abundant natural resources on a larger scale.

A BRIGHT FUTURE

The stars suggest a bright future for Indonesia. The country seems to be moving in the right direction. The social programs will bring millions out of poverty and harness the power of its youth for a promising economic growth trajectory. The economic strategy should be successful as long as Widodo doesn't get sidetracked by internal political dynamics, many observers believe.

Just how Widodo leads his country through global economic challenges will determine how Indonesia will take the world stage. "Growth projections are still reasonable. I'd give him a very cautious thumbs-up," says Nichols.

SCG CEO Kan Trakulhoon: ‘We Stand for Excellence in Managing People’

SCG OF THAILAND IS ONE OF THE COUNTRY’S LARGEST CONGLOMERATES with fiscal 2014 consolidated revenues of more than 487 billion baht (US$15 billion) and profits of 33.6 billion baht (US$1.03 billion). Like other companies in Thailand, it experienced tough times during the financial crisis of the late 1990s. The real strength, which stood the diversified manufacturing group in good stead when the tide turned, was the commitment to human resources excellence, says president and CEO Kan Trakulhoon. "We did not lay off or fire any employees," he explains in a wide-ranging discussion with Ravi Aron, professor at Johns Hopkins Carey Business School, and Knowledge@Wharton.

Below are edited excerpts from the transcript:

Ravi Aron: SCG has just celebrated its centenary [Siam Cement, the original parent company, was set up in 1913]. What was the vision when SCG was founded? What was the role that it was going to play in the Thai economy when it was set up 100 years ago under a royal charter?

Kan Trakulhoon: [For the centenary] we collated all the data and information, and documents. We found many valuable documents from the past. [SCG started] from the vision of King Rama VI. He wanted to establish a cement factory for the development of the country. At that time, there were only a few cement plants in the entire region. We used a lot of wood for construction of houses. But we had also started to import cement.

When King Rama VI went to Europe, he saw a lot of solid construction using cement. So he had this vision. Siam Cement was the only heavy industry in Thailand and in the entire region as well. We have been a pioneer for heavy industry; later on, we also started the first steel mills in Thailand and many other businesses.

Aron: What are some important milestones in SCG’s history? What would you say are some key defining moments?

“In 1997, we had about 140 companies — active companies…. In one year, we sold 56 or 57.”

Trakulhoon: We started in 1913. In the first 60 years, we were managed by four Danish CEOs. We had bought all the cement manufacturing machines from one company — FLSmidth of Denmark. We had the first Thai CEO just about 40 years ago. I am the 10th CEO and the sixth Thai CEO.

In 1972, after 61 years, we started to “group” the companies. I do not know [whether it is more appropriate to say] restructuring or grouping. By that time, we had several businesses. We had about six companies. So we grouped them and, for the first time, used the words Siam Cement Group. This was five years before I joined in 1977. By that time, we were already known as the Siam Cement Group.

Another important milestone was when the Stock Exchange of Thailand (SET) was started in 1975. We were one of the first listed companies. Eight companies were listed that year. But only four have survived; four were delisted.

Another milestone was during the Asian financial crisis in 1997. As one of the largest companies in Thailand at that time in terms of assets and revenue, we faced a lot of problems. We had a large debt which ballooned as the baht depreciated. In 1998, the debt was roughly about 247 billion baht (about $13 billion then).

At that time, the baht fell to its lowest level of 57 [to the dollar]. By January 1998, it was back to about 45. Today, it is about 32-33. We started major restructuring in August-September 1998. The crisis started on July 2 when the Thai government devalued the baht. But we recovered quite fast.

I was the head of the restructuring team, working with McKinsey. We spent about five weeks looking at the options. We identified three core businesses: cement, paper and chemicals. Even building materials and ceramics were branded only potential core. A few years later, we included them in our core businesses.

"The public sees us as a good corporate citizen, not only in Thailand but also in ASEAN."

I think this was the biggest restructuring ever in the group's history. We sold more than 60 companies. In 1997, we had about 140 companies — active companies — and we sold more than 60. In one year, we sold 56 or 57. We had a lot of joint ventures — for example with Michelin. In some, we sold 100%. But in the case of Michelin, we reduced from 55% to 40% [share]. We hold 10% now. We will sell the rest of the shares later on.

The number of people also reduced from 35,000 for the consolidated group to approximately 16,000 in 2002. Right now, we have about 49,000 employees. But we did not lay off or fire any employees. We sold companies, mainly to our partners and the employees attached to that company no longer belonged to us. By 2002, we recovered and turned profitable.

In 2006, we announced our vision: to be recognized as a successful business leader by 2015. For 100 years, we had no vision statement at all for the conglomerate. We had a vision for each business unit — for cement, for building materials, for paper. But, as a conglomerate, we never established any vision statement. In 2006, we started to do so. In August 2002, I had been informed by the board — by my predecessor — that they had selected me to be the next president. I would be president and CEO from 2006 to 2015. I had about three-and-a-half years to prepare myself.

My team — my junior team and I — developed this vision together. The formation of the vision started from 2004, but we got approval only after I became president in August 2006.

In 2013, we integrated three businesses — cement, building materials and distribution — into one. We called it the SCG cement building materials (CBM) group. So, today, we have three core businesses — the CBM group, the chemicals group and the paper group. Another activity is investment. Investment is the one non-core asset from the old days.

These are all the big milestones for the company.

Aron: One of the things I was struck by was when you said that when the financial crisis happened in 1997 and you sold many of your companies, you did not lay off anybody — even at the height of the crisis. Was it your intention to preserve the integrity of the workforce or did it just turn out that way?

Trakulhoon: It is something that impresses me, too. At that time, I was working in Jakarta. I learned that the crisis was very serious for the company. The currency had depreciated so much. We lost a lot — about 56 billion baht in 1997. But I talked with the boss and we believed we could afford it. But the human capital cost [is something we could not afford].

The management also saw that, if we laid off people, we would create more problems for society. The country was in very bad shape; 56-57 financial institutions had collapsed. There were a lot of layoffs and it was a very difficult situation. The interest rate was also increased to 20% or something like that. There was no money, no cash.

The management took some measures. When the baht depreciated, we allocated all our resources for exports. Domestic demand dropped by about 50%. There was new capacity — new plants — starting up in 1998 and 1999. So we put all our resources behind exports. This helped.

Anyhow, the key is that we value our people. We had to stand by that. Also, we believed that we would recover. So, when we recovered, we would have to have our people ready. The speed of recovery would be much faster if we had good people with us. We were mainly in manufacturing; we needed [expert] knowledge. That is one of the issues. If we have people, we must take care of them. It is not only retaining our employees; we had to also do a lot of training. We continue to provide training, even for new recruits.

We did not stop recruitment. At that time, most of the country had stopped recruitment. But we still recruited about 200 to 300 new employees. They held bachelors and masters degrees; some were PhDs. Normally, we recruit 500 to 600 people a year. Last year, it was 900. I think that is good.

So we had good people ready. When opportunity came to us, we recouped. In 1998, it was really bad. After 1998, we exported to ASEAN countries. But there was still a crisis because Asia had a crisis. In Thailand, by that time, we had no layoffs at all. It was quite calm and people were collaborating with the government. So we passed through all these crises quite peacefully. Back in 2001, we had already started to recover. We repaid all the debt on time with no problems.

Aron: The one question I want to ask you is: Companies are often known for something extraordinary — a source of excellence about them. At Toyota, they talk about manufacturing excellence. At Apple, they talk about innovation. Singapore Airlines is seen as a lighthouse company for customer centricity and customer service. How do you see SCG? What are the things that SCG is known for?

Trakulhoon: To tell you frankly, even I do not know.

But in Thailand we have the TMA — the Thailand Management Association. They do a survey of the top companies in Thailand. At the beginning of every year, they send a questionnaire to the CEOs of the top 500 companies by revenue. They have six or seven categories — human resource management excellence, quality of services, innovation, marketing, CSR, environment, things like that.

For 10 or 11 years in a row — from Day One — we have been No. 1 for excellence in human resource management. For CSR and the environment, we have gotten [the excellence award] seven or eight times, or we have been No. 2. This is from the survey. In innovation, we have been No. 1 for the past six years in a row. In the beginning, there was Nokia, Samsung, consumer products and things like that. But, amazingly, in the past six years, we have got it.

In human resources, I think we have done quite a good job. The management, from generation to generation, looks at human resources very carefully and with dedication. I myself spend a lot of time on this. I teach classes at SCG and I share my knowledge with outsiders as well. We also won the SET Award for corporate governance. The public sees us as a good corporate citizen not only in Thailand but also in ASEAN. So, if you ask [me to define what SCG stands for] I will say people excellence….

Knowledge@Wharton: You said you grew mainly through M&A. But what was your approach to developing a global mindset among your own executives so that they would learn to think globally and also pay attention to local market conditions?

Trakulhoon: I talked to my HR team [and asked,] "How can we strengthen our core values until 2015?" We developed our new culture. We would like to develop our culture to be an innovative one. That's why the informality. We stopped wearing ties. We took away uniforms. We strengthened our four core values and we added another two words — open and challenge.

Many of the companies we took over in Thailand were listed. They had very different cultures. We asked them to follow our four core values. They would also have to be open. They would have to challenge. But that could come later on.

Our due diligence team has to work with the company after we have taken it over. They have to train the employees. That is our strategy.

"Our due diligence team has to work with the company after we have taken it over. They have to train the employees. That is our strategy."

[Our greenfield cement plant project in Myanmar] is much easier because we recruit new staff. We send them to Thailand to be trained and also to absorb our culture — our working culture, collaborative culture, teamwork culture. At the very beginning, we instill the four core values. The culture issue has been very important to drive the company forward. If we can win the hearts of the employees, we can get good results.

Aron: What is your vision in this extraordinary investment that you are making in human resources in SCG?

Trakulhoon: This is the culture of sharing knowledge in the company. We have a lot of classes internally and also open classes. We have sent people to Harvard, Wharton…

Knowledge@Wharton: That is truly impressive. Could I ask what your personal philosophy about managing people is?

Trakulhoon: I don't know if you know the word metta.

Knowledge@Wharton: Yes. I am familiar with metta. It is a well-known Buddhist term. I think it means loving kindness in Buddhist philosophy.

Trakulhoon: Yes. Yesterday, I spent two hours with my new recruits — a group of 119. I talked for two hours. I spent two hours with them for the first session. We spent almost a month training these new recruits. So I really feel a bit tired. Last week, I spent three hours with the section heads — with a group of almost 120-130. I told them I wanted to share my knowledge with them to make them better. I want them also to do the same. This is my philosophy.

And, of course, I really adhere to our four core values (adherence to fairness; belief in the value of the individual; dedication to excellence, and concern for social responsibility).

Fairness. I can swear to you I never make any decision about our human resource management with any bias. And that's from Day One, when I took charge. I never abuse my power. I am also very ethical. I think this is very important. Leaders have to be very ethical because you have to settle a lot of issues. Ethically there is only one way but if you want to do some other things you have a hundred other ways. With fairness, we can have a lot of good friends.

I am not really result-oriented. I never set very challenging targets. If the process is good, we positively agree on the target. Then we reach the target and we get a good result. ❋

Special Report

ASEAN on the Rise

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